

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 216

June 24, 1958

INTEREST: DISALLOWANCE OF DEDUCTION: INADEQUATE CAPITALIZATION

Syllabus:

Amounts paid stockholders as "interest" on debts arising from the sale of assets to a corporation are in reality dividends where the corporation is inadequately capitalized.

X Co. was incorporated in November, 1954 for the purpose of building and selling homes. The two incorporators paid in \$375 each and each acquired 50% of the capital stock. Nine days later, X Co. borrowed \$6,000 on an unsecured note from an insurance company. Then X Co. contracted to purchase 27 lots from the incorporators paying \$5,485 down, which was approximately 10% of the purchase price. The balance was an unsecured obligation and drew interest of 5% per annum. In December X Co. obtained a construction loan of \$250,000 and gave a deed of trust on the 27 lots as security. After completing its building and selling program, X Co. dissolved in November, 1955. Advice is requested whether the amount paid as "interest" on the land purchase contract is deductible as an interest deduction.

The deductibility of amounts paid as "interest" depends upon whether the underlying transaction is a true loan or a sale of assets. However, if the underlying transaction is in reality an investment of equity capital such payments are considered as dividend payments and are not deductible. Although such a determination is necessarily a factual determination, the courts emphasize the adequacy of the initial capitalization. In the instant case, the stock investment was a nominal investment in view of the scope of the building program. The ratio of debt to stock investment after the two unsecured notes was 69 to 1 and after the construction loan it was approximately 403 to 1. These ratios evidence the "nominal stock investment and an obviously excessive debt structure" to which the Supreme Court referred in Comm. v John Kelly Co., 326 US 521, where they expressed the belief that interest and bad debt deductions should be disallowed in such cases.

The courts have held so-called "loans" to be investments of equity capital where the ratio of debt to stock was not as unfavorable to the taxpayer as 69 to 1 in many instances. The same principle has been applied in denying interest deductions on "interest" payments which have been made on the alleged sales of assets by stockholders to the corporation. Robert L. Osborne, TCM 1954-7; R. M. Gunn et al, 25 TC 424; Old Colony Inc., 26 TC No. 3. In the instant case, the incorporators interest in the alleged debt due them was in proportion

to their stockholdings. Not only was the debt unsecured but the incorporators knew that the property would be mortgaged for the construction loan and if the venture failed they would not be repaid. Therefore, the property must be considered as having been put in as risk capital and the "interest" paid amounts to a dividend. Consequently they cannot be deducted as interest payments.